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SIGNIFICANT PROCEDURAL AND SUBSTANTIVE CHANGES IN SECURITIES LAWS UNDER THE PRIVATE SECURITIES LITIGATION REFORM ACT

by

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The decade of the 1990's has been a time when an unprecedented number of people have invested in the stock markets. Through 401-K plans, mutual funds, IRA accounts, pension funds, and decisions made by individual investors, money has flowed into securities in huge amounts. Trading volume on the New York Stock Exchange, NASDAQ, and the American Stock Exchange has reached hitherto unrealized heights. It is now common to see trading volume of 300-400 million shares per day on the New York Stock Exchange. NASDAQ volume frequently exceeds that of the New York Stock Exchange. On May 23, 1996, e.g., over 725 million shares were traded on NASDAQ alone.

While stock prices have generally risen and market averages have reached historic highs during the 1990's, this period has been a time marked by trading volatility and wide price swings. In terms of stock prices, good news is often generously rewarded while bad news, e.g., disappointing earnings, brings severe punishment. With increased interest and participation in the stock markets, high trading volume, and broad and volatile price swings has come a large increase in lawsuits alleging violations of the securities laws. A high percentage of these lawsuits alleged some sort of securities fraud. Regrettably, a substantial number of the lawsuits alleging fraud in securities transactions have been found to be abusive and meritless.

The Private Securities Litigation Reform Act of 1995[1] ("The Act") became law on December 22, 1995, when Congress overrode the veto of President Clinton. The act significantly amends the Securities Act of 1933 (the "1993 Act") and the Securities Exchange Act of 1934 (the "1934 Act"). This new legislation makes important substantive and procedural changes to the basic laws which regulate the securities industry. The laws governing private securities litigation, especially class actions, have been reformed by the Act. This paper will focus on the new rules, substantive and procedural, governing private litigation under the Act.

A main objective of the Private Securities Litigation Reform Act is to limit strike suits. A "strike suit" may be defined as a "shareholder derivative action begun with hope

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of winning large attorney fees or private settlements, and with no intention of benefiting the corporation based on a claim that the defendant committed fraud. In the 1990's, strike suits became a particular problem in volatile technology companies where disappointments in earnings frequently caused big downward moves in the price of the shares. Many of these lawsuits were perceived to have been abusive in nature and brought with the hope of extracting high settlements including the payment of legal fees. According to one commentator, the legislation will provide much-needed relief to public corporations, "clamp(ing) down on the parasitic 'strike suit' cottage industry--shareholder class actions routinely filed by enterprising plaintiff's lawyers who see fraud whenever stock prices decline in the hope of reaching a settlement."[3]

Safe Harbor Provisions

The Act amends and dramatically changes both the 1933 Act and the 1934 Act with regard to liability for false and misleading statements for forward-looking statements. The Act creates a safe harbor from liability in private actions, i.e., those not begun by the government, for a forward-looking statement which is false or misleading provided the forward-looking statement, written or oral, is "identified as a forward-looking statement, and is accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the forward-looking statement."[4] This should allow corporations to issue earnings projections and make statements concerning projected corporate developments with less fear of being subjected to lawsuits in the event the earnings or developments do not materialize.

The safe harbor provisions of the Act expand the safe harbor protections which were available under SEC Rule 175. Under Rule 175, safe harbor protection applied to forward-looking statements but only if those statements were included in documents filed with the SEC. Accordingly, the protection of Rule 175 was relatively narrow and left unprotected large areas of vulnerability, e.g., press conferences, interviews, and situations where verbal discussions or announcements take place. The Act's provision for the safe harbor has much in common with the "Bespeaks Caution Doctrine," developed and applied by some, but not all, of the federal courts. "The essence of the Bespeaks Caution Doctrine is that forward-looking statements when accompanied by adequate cautionary language are not actionable as securities fraud."[5]

Among others, corporations, corporate spokespersons, and underwriters should be aided by the safe harbor provision. "The SEC wants to encourage companies to talk about what they anticipate happening in the near future but without the strengthened safe-harbor provision, companies were open to what is called 'fraud by hindsight,' or earnings failing to rise as predicted in company literature being interpreted as corporate fraud."[6] Under the law as it now stands, the likelihood is that the chief financial officer or another appropriate officer will routinely identify and disclose the business factors that might cause the forecasts not to materialize.

The safe harbor provision is further strengthened by another protection in the Act which provides that no liability will attach in any event to forward-looking statements unless the statement or projection is made with actual knowledge that the statement was false or misleading.[7] The Act expressly sets forth that to impose liability for a forward-looking statement, if the statement was made by a natural person that person had to have actual knowledge that the statement was false or misleading.[8] If the statement was made by a business entity, proof is required that the statement was made by or with the approval of an executive officer of that entity and the officer had actual knowledge that the statement was false of misleading.[9] This provision of the legislation would protect even against a charge of constructive fraud, i.e., fraud based on proof that the speaker's statements showed a reckless disregard for truth, accuracy, and completeness. Similarly, forward-looking statements or projections in which the speaker was grossly negligent in making the statement or projection would be protected. As the law now stands, if the plaintiff alleges fraud, it will be necessary to prove that the defendant acted with the intent to deceive or defraud.

The availability of the safe harbor for forward-looking statements provides substantial protection, but it should be noted that this protection does not apply to registration statements for initial public offerings filed with the Securities Exchange Commission (the "SEC").[10] In addition, the safe harbor provisions may be used only by "reporting companies," i.e., those required to report to the SEC by the 1934 Act.

To ensure that a jury adheres to the requirement of liability based on a finding that the speaker had actual knowledge that the statement was false or misleading, a defendant may demand that interrogatories by submitted to the jury on that point.[11] Similarly, in a case decided by the Court, the judge must issue a specific finding that the defendant acted with such knowledge.[12]

Those issuing forward-looking statements are further protected by a provision in the statute which provides that there is no duty to update forward-looking statements.[13] Should events unfold which cause the projection not to be true, therefore, the Act imposes no obligation to correct the projections or to keep them current.

Limitations on Discovery

One tactic of unscrupulous plaintiffs bringing strike suits has been to initiate a lawsuit alleging fraud, but without specifying in the pleadings the offensive conduct. Then, the plaintiff would seek extensive discovery proceedings by which the plaintiff would attempt to uncover specific conduct sufficient to support an award for fraud or simply make the proceedings so onerous and expensive that a defendant company would be forced to settle the matter. The Act attempts to bar "fishing expeditions" of this type by requiring that in a lawsuit in which recovery will be based on a state of mind, typically fraud, the complaint must specify the statement(s) which form the basis of the complaint and why the statements were false or misleading.[14] The plaintiff must plead facts raising a strong inference that the defendant acted with the required state of mind. Upon a motion to dismiss the complaint for failure to allege facts sufficient to raise a strong inference of a culpable state of mind by the defendant, all discovery proceedings must be stayed by the Court pending the determination of the motion.[15] In this way, lawsuits lacking substance may be dismissed at an early stage of the proceeding freeing corporate officers from the burden- some task of defending against unfounded charges. This, of course, results in great savings to corporations and avoids the corporation having to make the choice of defending or settling a meritless claim.

To further strengthen this provision, sanctions must be imposed by the Court for instituting actions deemed by the Court to be lacking substance because they are found to be frivolous in nature.[16]

The legislation makes clear that frivolous and "abusive" litigation is to be punished. The Act requires that the court make findings indicating whether there has been a violation of Rule 11 of the Federal Rules of Civil Procedure. Rule 11 aims at the prohibition of abusive and obviously groundless actions. At the outset of the lawsuit, the court may require an undertaking from plaintiffs and/or plaintiffs' attorneys for costs that may be awarded to the defendant. Upon a finding of a violation of Rule 11, the court must impose sanctions. It would seem that at a minimum a plaintiff found to be in violation of Rule 11 would be required to pay the defendant's attorneys' fees and court costs. Where the court has taken the precaution of having the plaintiff and/or its counsel post an undertaking, the funds would then be readily available.

Class Action Reforms

Class action lawsuits pose particularly difficult problems for corporate defendants since the liability for damages may be many times greater than in the case of a single plaintiff. In some cases, a plaintiff who had invested and lost a modest sum, inspired by counsel anxious to allege securities fraud, would institute an action and have the case certified as a class action.

All plaintiff class action lawsuits are affected by changes made by the Act. To lessen the chances of parties bringing abusive lawsuits and gaining control of a class action, the "most adequate plaintiff," also called the lead plaintiff, is presumed to be the party who has the largest financial interest in the matter,[17] e.g., an institutional investor. The lead plaintiff has the right to retain the counsel to represent the class. A plaintiff with a small amount at stake who initiates the action and the counsel selected by that plaintiff may therefore be replaced by the court and a different lead plaintiff and its counsel installed.

The lead plaintiff and its counsel generally have the greatest impact on the course of the litigation, but limitations have been imposed by the Act on the power of the lead plaintiff to settle actions. The lead plaintiff does not have the sole discretion to reach settlements for the class. Any proposed settlement must be published along with a brief explanation as to the reasons for support or opposition to the settlement by the lead plaintiff.[18] This affords other members of the class the opportunity to make its position known.

To discourage lawsuits aimed at obtaining unreasonably large attorneys' fees rather than true redress for aggrieved plaintiffs, attorneys' fees are limited to a reasonable percentage of the damages and interest recovered for the class.[19] In addition, it must be certified in the pleadings that the plaintiff did not purchase the shares in order to participate in the action and that the plaintiff will not accept any payment for serving as a representative party for the class beyond a pro rata share of any recovery.[20]

The requirement that the court appoint the most adequate plaintiff to represent the class and the opportunity of that plaintiff to select counsel, the limitation of attorneys' fees to a reasonable percentage of damages and interest recovered by the class, the prohibition against lead plaintiff receiving anything more than a pro rata share of the recovery should alleviate the twin problems of "professional" securities fraud plaintiffs and "lawyer-driven' lawsuits in which certain attorneys routinely represented plaintiffs who had a relatively modest financial interest in the lawsuits.

Changed Responsibilities and Liabilities of Accountants

The Act expands the responsibility of accountants, but also places strict limitations on their liability.[21] Concerning expanded responsibility, accountants must use procedures that: provide reasonable assurance of detecting illegal acts; identify related party transactions; evaluate whether there is substantial doubt about the ability of the issuer to continue as a going concern during the ensuing fiscal year. If the accountant determines that an illegal act has been committed, unless the illegality is inconsequential, the accountant must inform management of the issuer and its audit committee.[22] In the event the issuer does not have an audit committee, the issuer's board of directors must be notified.

If the accountant determines that the issuer has not taken appropriate remedial action after being notified of the illegal act that the accountant reported and the failure to take remedial action will cause the auditor to depart from issuing a standard report or resign from the audit engagement, the accountant must notify the SEC and furnish it with a copy of the report which had been made to the audit committee and/or board of directors of the issuer.[23] In this way, the company is given an opportunity to take remedial action upon receiving notice that some illegal act or course of conduct has taken place. If, however, in the opinion of the auditor, the company does not take appropriate action, then the SEC must be informed.[24]

While the accountant's responsibilities are somewhat expanded, the liability of auditors for damages may be greatly reduced by the provisions of the Act. The previous joint and several liability of the accountant and other liable parties, generally the corporation and its officers, is replaced by proportionate liability.[25] The accountant is no longer liable for the entire judgment unless the trier of the facts specifically determines that the accountant knowingly committed a violation of the securities laws. In those cases based on negligence, e.g., the liability of the accountant will be limited to the portion of the loss caused by the accountant. The Act provides, " ... a covered person against whom a final judgment is entered in a private action shall be liable solely for the portion of the judgment that corresponds to the percentage of responsibility of that covered person." [26] An accountant who caused 10 percent of the loss, e.g., would be responsible for 10 percent of the damages.

Establishing proportionate liability essentially precludes the possibility that an accountant who acted in good faith will be responsible for paying the entire judgment. This consideration would be particularly important in a situation where liability is imposed and the co-defendant corporation becomes insolvent. Before this change in the law, where a financially sound accounting firm was held liable along with a financially troubled corporate defendant which became insolvent, the result generally was that the accounting firm paid the entire judgment. Referring to the change to proportionate liability, an article in the Wall Street Journal stated:

> The change could save the firms staggering sums in the event of a major calamity such as the savings-and-loan crisis, which forced the Big Six accounting firms to pay more than $1.6 billion in damages and settlements to investors. And it will reduce their payouts for judgments in other, more routine cases.[27]

It should be noted, however, that there is a deviation from the rule of strict proportionality of responsibility where the principal defendant, the corporation, is insolvent. In such a case, the accountant may be responsible for an additional amount equal to not more than an additional 50 percent more of the amount that the accountant would otherwise be required to pay.[28]

To ensure that the provision of the law establishing pro-portionate liability is followed, the Court must instruct the jury to answer interrogatories establishing the percentage of responsibility of each defendant and determining whether the defendant accountant knowingly committed a violation of the securities laws. Where the judge decides the case without a jury, the judge must make a similar finding determining percentage of responsibility and whether the violation of the securities laws by the accountant was a knowing violation of law.[29]

Conclusion

As the title of the Act indicates, the Act is designed to reform the rules for private securities litigation. The changes, both substantive and procedural, should dramatically restrict the number of lawsuits based on fraud. The safe harbor provisions for forward-looking statements - "meaningful cautionary statements" and the requirement of proof of actual intent to defraud - will make it extremely difficult to recover for predictive statements made by corporations.

The procedural changes imposed by the Act - the limitations on discovery, the requirement of pleading specifically the alleged fraudulent statements, the changes concerning the lead plaintiff and other modifications of the class action rules, the requirement of sanctions for the institution of abusive litigation - strongly support the substantive changes and should curtail the strike suits against which much of the legislation is aimed.

The Act also expands the responsibilities of accountants to report illegal activities, but also provides protections for accountants. The provision that accountants will be liable only for the percentage of the loss caused by their conduct absent a finding that they knowingly violated the securities laws will significantly curtail their liability.

As always, court cases will interpret the legislation. There should be, however, no doubt that the Act will have a profound effect on the private securities litigation landscape.

ENDNOTES

1. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67.

2. Black's Law Dictionary 1423 (6th Ed.).

3. *Good Veto . . . Bad Veto: President Clinton Caves to Trial Lawyers, But Congress Saves the Day*, Pitt. Post-Gazette, Dec. 29, 1995, at A12.

4. Pub. L. No. 104-67 § 102.

5. Jeanne A. Calderon and Rachel S. Kowal, *Safe Harbor Rules for Forward-Looking Financial Date*, J. of Financial Statement Analysis 60,63 (Spring 1993). For an excellent analysis of SEC Rule 175 and "Bespeaks Caution Doctrine," see id.

6. Anne Eisele, *Litigation Bill Override Hailed: But Not By All*, New Technology Week, Jan. 2, 1996.

7. Pub. L. No. 104-67 § 102.

8. *Id.*

9. *Id.*

10. *Id.*

11. Pub. L. No. 104-67 § 101.

12. *Id.*

13. Pub. L. No. 104-67 § 102.

14. Pub L. No. 104-67 § 101.

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

21. Pub. L. No. 104-67 § 301.

22. *Id.*

23. *Id.*

24. *Id.*

25. Pub. L. No. 104-67 § 201.

26. *Id.*

27. Jeffrey Taylor, *Congress Sends Business a Christmas Gift: Veto Is Overridden on Bill Curbing Securities Lawsuits*, Wall St. J., Dec. 26, 1995, at A2.

28. Pub. L. No. 104-67 § 201.

29. *Id.*

Treacherous Waters for White Water Rafters: Outfitters' Exculpatory Contracts and White Water Responsibility Acts

by

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Introduction

White water rafting has become a popular form of risk taking adventure travel. Estimates are that two million Americans participate in the sport but there are no figures on the number of fatalities.[1] While many people safely enjoy guided rafting trips, many find their experiences more dangerous than anticipated. Because some participants have suffered injuries or death, lawsuits have been brought in some states.[2]

This article will discuss three important cases involving white water rafting accidents: *Saenz v. Whitewater Voyages, Inc.*[3] which outfitters regard as significant [4], and two West Virginia cases: *Krazer v. Mountain River Tours, Inc.*[5] and *Murphy v. North American River Runners.*[6] This article will also examine states' *White Water Responsibility Acts.*

In *Saenz v. Whitewater Voyages, Inc.*, Saenz was a healthy 28 year old man who had been recruited to join a three day rafting trip from June 20-22, 1988 on the Middle Fork of the American River in California.[7] Before beginning the trip, all participants including *Saenz* completed and signed *"Release and Assumption of the Risk Agreement"* which stated:

> I am aware that certain risks and dangers may occur on any river with Whitewater. These risks include, but are not limited to, hazards of injury to person and property, while traveling in rafts on rivers, accidents or illness in remote places without medical facilities and the forces of nature...
>
> I hereby assume all of the above risks and, except in cases of gross negligence, will hold Whitewater...harmless from any or all liability, actions, causes of action, debts, claims, and demands of every kind and nature whatsoever, which I now have, or which may arise out of, or in connection with, my trip or participation in any activities with Whitewater..."[8]